Office of Chief Counsel
Internal Revenue Service

memorandum

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date:

to: Examination Division, Southern California District, Laguna Niguel
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from: District Counsel, Southern California District, Laguna Niguel
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subject: **Research and Experimental Expenditures** [redacted]

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ISSUE

Whether the taxpayer's expenditures were for the acquisition of another's production or process (or incurred in connection with the construction or manufacture of depreciable property by another) and, if so, whether such expenditures were at the taxpayer's risk or pursuant to a performance guarantee?

CONCLUSION

The taxpayer's expenditures were for the acquisition of another's production or process and not at the taxpayer's risk.

FACTS

[redacted]. ([redacted] or the taxpayer) is in the business of developing and marketing [redacted].

In fiscal years ending April 30, [redacted] through [redacted], [redacted] claimed a deduction for research expenses pursuant to section 174 in the amounts of $[redacted], $[redacted], and $[redacted], respectively. [redacted] filed an amended return for the fiscal year ending April 30, [redacted], claiming a deduction for research expenses pursuant to section 174 in the amount of $[redacted]. The claimed expenses arose from three standard contracts: A standard Product Agreement, a standard Product License Agreement and a standard Independent Contractor Agreement.

Standard Product Agreement

[redacted]:

(1) [redacted].

(2) [redacted].

Under the terms of the agreement:

[redacted]

[redacted] had the right to request any and all modifications which it deemed necessary to adapt the Work to its specifications. The Work was not deemed accepted until all modifications requested by [redacted] had been made by the Developer.

[redacted] reserved the right to terminate the Agreement at any time for any reason. If terminated, the amounts paid by [redacted] under the Agreement to the developer were non-refundable, unless termination occurred as a result of a breach of the developer's representations and warranties. The developer represented and warranted the following:

[redacted]

[redacted]

(1) [redacted]

[redacted]

(2) [redacted]

(3) [redacted]

The parties were required to set forth a schedule of milestones.

Standard Product License Agreement

[redacted]

[redacted]

[redacted]

(a) [redacted]

(b) [redacted]

(c) (i) [redacted]

[redacted]

(ii) [redacted]

[redacted]

(iii) [redacted]

[redacted]

[redacted]

Standard Independent Contractor Agreement

[redacted]

[redacted]

LAW AND ANALYSIS

A taxpayer may treat research or experimental expenditures which are paid or incurred by it during the taxable year in connection with its trade or business as expenses that are not chargeable to the capital account. I.R.C. § 174(a)(1). A taxpayer is generally allowed the election of either currently deducting its research and experimental expenditures or amortizing those expenditures over a period of not less than 60 months. I.R.C. §§ 174(a)(1), (b)(1); Treas. Reg. § 1.174-1. Research expenses that are neither treated as expenses nor deferred and amortized must be charged to the capital account. Treas. Reg. § 1.174-1.

In general, research and experimental expenditures are those "which represent research and development costs in the experimental or laboratory sense." Treas. Reg. § 1. 1 74-2(a)(1). The term generally includes all such costs incident to the development or improvement of a product. Treas. Reg. § 1.174-2(a)(1). "Product" includes any pilot model, process, formula, invention, technique, patent, or similar property and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease or license. Treas. Reg. § 1-1742(a)(2). It does not include the acquisition of another's production or process. Treas. Reg. § 1.174-2(a)(3).

Section 174 applies to costs paid or incurred by a taxpayer for research and experimentation undertaken directly by the taxpayer and to costs paid or incurred for research or experimentation carried on in the taxpayer's behalf by a third party. Section 174 does not apply to costs paid or incurred that represent expenditures for the acquisition or improvement of depreciable property, used in connection with the research or experimentation, to which the taxpayer acquires rights of ownership. Treas. Reg. § 1.174-2(a)(8).

If expenditures for research or experimentation are incurred in connection with the construction or manufacture of depreciable property by another, they are deductible under section 174(a) only if made upon the taxpayer's order and at its risk. No deduction is allowed if the taxpayer purchases another's product under a performance guarantee (whether express, implied, or imposed by local law) unless the guarantee is limited, to engineering specifications or otherwise, in such a way that economic utility is not taken into account. Treas. Reg. § 1.174-2(b)(3).

Under the given facts, the amounts paid pursuant to the

standard Product Agreement, standard Product License Agreement, and standard Independent Contractor Agreement are deductible if made upon [redacted] s order and at its risk.

Standard Product Agreements

In the standard Product Agreement, [redacted] would establish specific property that contained specific requirements to be developed on a work-for-hire basis. [redacted] had the right to request any and all modifications that it deemed necessary to adapt the product to its specifications, and the Work was not deemed acceptable until all modifications requested by [redacted] had been made by the developer.

[redacted] paid the developer on a milestone basis when [redacted] believed the milestone had been met. If [redacted] did not believe a milestone had been achieved, [redacted] would notify the developer with comments regarding the rejection and the developer was to submit or resubmit the materials to [redacted]. This process would be repeated until [redacted] determined that the milestone had been met or that further submission would be to no avail. If further submission would be to no avail, [redacted] could immediately terminate the agreement. If terminated, the amounts paid by [redacted] under the agreement to the developer were non-refundable, unless termination occurred as a result of a breach of the developer's representations and warranties. In addition, the developer had to make any necessary corrections for [redacted] errors discovered after acceptance of the final [redacted] at its own expense.

The agreement provides that the [redacted] produced by the developers would be the exclusive property of [redacted] and all materials produced by the developers in fulfilling their obligations under the agreements are works made for hire. The developer had no claim to any right, title or interest in the Work.

[redacted] had the right to request any and all modifications that it deemed necessary to adapt the Work to its specifications. The Work was not deemed accepted until all modifications requested by [redacted] had been made by the developer. If at any time after acceptance of the Work a [redacted] appeared, the developer was required to correct the [redacted] at the developer's own cost and expense.

Based on the terms of the standard Product Agreements, the developers were responsible for the operability of the [redacted] according to [redacted]'s specifications. Accordingly, the standard Product Agreements were contracts for the purchase of [redacted].

Standard Product License Agreement

The Standard Product License Agreement was used to purchase exclusive worldwide [redacted] rights to existing [redacted]. Research and experimental expenditures do not include the acquisition of another's production or process. Treas. Reg. § 1.174-2(a)(3). Accordingly, the amounts paid pursuant to the licensing agreement for the purchase of exclusive world-wide [redacted] rights to existing [redacted] are excluded from the definition of "research and experimental expenditures" and are not deductible under section 174(a).

Under the standard Product License Agreement, consideration was also paid for the conversion or modification services provided by the licensor. [redacted] would establish specific modifications and the product was not deemed acceptable until all requested modifications had been made by the licensor.

[redacted] had the right to request any and all reasonable modifications that it deemed necessary to adapt the product to its specifications. The product was not deemed accepted until all modifications request by [redacted] had been made by the licensor. If at any time after acceptance of the product a [redacted] appeared, the licensor was required to correct the [redacted] at the licensor's own cost and expense.

[redacted] paid the licensor on a milestone basis when [redacted] believed the milestone had been met. If [redacted] did not believe a milestone had been achieved, [redacted] would notify the licensor with comments regarding the rejection and the licensor was to submit or resubmit the materials to [redacted]. This process would be repeated until [redacted] determined that the milestone had been met or that further submission would be to no avail. If further submissions would be to no avail, [redacted] could immediately terminate the agreement. If terminated, the amounts paid by [redacted] under the agreement to the licensor were nonrefundable, unless termination occurred as a result of a breach of the licensor's representations and warranties.

Within two weeks following the delivery of the product, [redacted] could determine if the [redacted] was acceptable. If [redacted] determined that the [redacted] was not acceptable, [redacted] could terminate the agreement or the licensor had [redacted] days to correct the [redacted]. After re-delivery of the product, [redacted] had [redacted] days to determine whether the product should be accepted or rejected. The process could be repeated until [redacted] either accepted the product or terminated the agreement. If terminated, [redacted]'s entire liability to the licensor was for payments already made, minus amounts recoupable as a result of any breach of

any representation or warranty by Licensor.

Any trademark or service mark which came into existence during the term of the agreement was owned exclusively by [redacted].

Based on the terms of the standard Product License Agreements, the licensors were responsible for the conversion or modification of the [redacted]. Accordingly, the standard Product Licensing Agreements were contracts for the purchase of [redacted].

Standard Independent Contractor Agreement

In the standard Independent Contractor Agreement, [redacted] would establish specific property that contained specific requirements to be developed on a work-for-hire basis. [redacted] paid the contractor on a milestone basis when [redacted] believed the milestone had been met. If [redacted] did not believe a milestone had been achieved, [redacted] could either terminate the agreement and/or supply, correct or complete the services and the deliverable items and deduct an amount equal to reasonable compensation for [redacted]'s efforts from any payments due under the agreement.

The agreement provides that [redacted] will be the owner of the copyright and all other proprietary rights in the work. The contractor had no claim to any right, title or interest in the work.

Based on the terms of the standard Independent Contractor Agreements, the contractors were responsible for the operability of the nontechnical aspects of [redacted] according to [redacted]'s product specifications. Accordingly, the standard Contractor Agreements were contracts for the purchase of [redacted].

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Treas. Reg. § 1.174-2(b)(3) does not support the position that each contract is made up of milestones and that each milestone must be examined to determine which party bears the requisite risk; rather, the regulation specifically states that research and experimental expenses are attributable to a product, and not to a product's components parts. See Treas. Reg. § 1.174-2(a)(1) and (2) (the term "product" includes products to be used by the taxpayer in its trade or business).

Under the standard Product agreement, [redacted] purchased a certain [redacted]. Under the standard Product License agreement, [redacted] purchased the exclusive rights to worldwide [redacted] rights. Under the standard Independent Contractor

agreement, [redacted] purchased certain nontechnical aspects of [redacted]. Accordingly, the "product" purchased is [redacted], world-wide rights, and nontechnical aspects, respectively.

Two recent cases concerning the research credit under section 41 are of limited value to the instant issue. Fairchild Industries v. United States, 71 F.3d 868 (Fed. Cir. 1996), rev'g 30 Fed. Cl. 839 (1994); Norwest v. Commissioner, 110 T.C. 34 (1998). Qualified research for purposes of the research credit is applied separately with respect to each business component of the taxpayer. I.R.C. § 41(d)(2)(A). A business component is any product, process, computer software, technique, formula, or invention which is held for sale, lease, or license, or used by the taxpayer in a trade or business of the taxpayer. I.R.C. § 41(d)(2)(B). Accordingly, the requirements of section 41(d) are applied to the business component being offered for sale, lease or license or used by the taxpayer in its trade or business. If the business component fails to meet the requirements of section 41(d), the taxpayer may shrink-back and apply the requirements to the next most significant subset of elements of the business component. In addition, the language in Treas. Reg. §§ 1.41-2(e) and 1.41-5(d), which addresses what party is entitled to the credit when there is contract research, is not the same as the language in Treas. Reg. § 1.174-2(b)(3). Because of the difference in approach between section 41 and section 174, the case law developed under section 41 is generally of limited value in determining whether a taxpayer is at risk for purposes of section 174.